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In the Supreme Court of the United States

OCTOBER TERM, 1977

UNITED CALIFORNIA BANK and LILLIAN DISNEY TRUYENS, CO-EXECUTORS OF THE ESTATE OF WALTER E. DISNEY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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The question presented in this federal income tax case involves the proper computation of an estate's tax on its capital gains. By the terms of his will, Walter E. Disney left 45 percent of the residue of his estate to the Disney Foundation and the California Institute of the Arts, both of which are tax-exempt charitable organizations. During 1967 and 1968, petitioners, as co-executors of the estate, sold certain securities that were part of the residue of the estate and realized long-term capital gain. In accordance with the will, 45 percent of the gain was set aside for the Disney Foundation (Pet. 2; Pet. App. 5).

There are two methods of computing the tax on long-term capital gains. Under the so-called "normal" method of Section 1202 of the Internal Revenue Code of 1954 (26 U.S.C.), the taxpayer includes the long-term capital gain in gross income, and then deducts 50 percent of the net long-term capital gains. Section 1201(b) prescribes the "alternative" tax, calculated in two steps and applied when resulting in a lower tax liability than the normal method. The first step computes a partial tax at the ordinary rates on the taxable income reduced by the long-term capital gain. This step effectively subjects only ordinary income to the partial tax. The second step imposes a 25 percent tax on the net long-term capital gain.

The question presented is whether, in computing its tax on capital gains, petitioners were entitled to exclude from the calculation the 45 percent portion set aside for charitable purposes. If it were so entitled, the alternative tax would have been less than the normal tax and therefore applicable.

In computing the estate's income tax for 1967 and 1968, petitioners deducted from its net long-term capital gain the portion that had been permanently set aside for charitable purposes, and then employed the 25 percent alternative tax computation. On audit, the Commissioner of Internal Revenue determined that petitioners could not exclude from the computations the capital gains set aside for the charity, and therefore concluded that the normal rather than the alternative tax was applicable (Pet. App. 5-6). In this refund suit brought by petitioners in the United States District Court for the Central District of California, the district court upheld petitioners' claimed refund on the authority of *Statler Trust* v. *Commissioner*, 361 F. 2d 128 (C.A. 2) (Pet. 5; Pet. App. 6).

The court of appeals reversed. It held that the capital gains tax computations permit no reduction for amounts set aside for charity (Pet. App. 4-15).

1. We agree with petitioners' assertion (Pet. 6-9) tha the decision below conflicts with *Statler Trust* v *Commissioner, supra.* There, a divided panel of th Second Circuit held that in computing its alternativ capital gains tax, a trust could deduct from its long-term capital gains the amount of those gains it was required to set aside for charitable purposes. As a result, the trust became eligible for the Section 1201(b) alternative tax computation.

In so holding, the court rejected the government's argument that there was no statutory basis for such a deduction because the language of Section 1201(b)(2)—which includes "net long-term capital gain" in the 25 percent tax base—means total net long-term capital gain. Although the Second Circuit acknowledged that the language of Section 1201(b) supported the government's position, it concluded that "the letter of § 1201(b) must yield when it would lead to an unfair and unintended result" (361 F. 2d at 131). The court rested its holding that the amounts set aside for charity could be deducted under Section 1201(b) because they fell within the general conduit principles of the taxation of trusts. See Sections 661, 662. In the court's view, the amounts set aside by the trust for charity were to be treated as never having belonged to the trust for tax purposes.

Here, however, the court of appeals expressly disagreed with the conduit analysis of *Statler Trust* (see Pet. App. 15). As the court observed, amounts distributed or set aside to charity are not excluded from the distributable net income of a trust, even when they consist of capital gains. See Section 643(a)(3). Moreover, the system of taxation of trusts does not exclude from income amounts distributed to charity but provides for an unlimited deduction for charitable distributions. See Sections 642(c), 662(a), 663(a)(2). Thus, the Second Circuit's

assumption that the conduit principles permit a trust to exclude net long-term capital gain distributed to a charity in computing the alternative tax erroneously permits a taxpayer to cumulate the benefits of a charitable deduction and the alternative capital gains tax computation.

2. Despite the acknowledged conflict of decisions, we do not believe that the question presented warrants review by this Court at this time. The Internal Revenue Service advises that there are no cases presently pending administratively or in the courts that involve the question. In the last 12 years, *Statler Trust* and this case have been the only decided cases addressing the question.

Moreover, since the Second Circuit's decision in *Statler Trust,* this Court in *United States* v. *Foster Lumber Co.,* 429 U.S. 32, has held in an analogous context that the Internal Revenue Code did not permit the cumulation of the benefits of the loss carryover provisions of Section 172 with the benefits of the alternative capital gains computation of Section 1201. While the computational issue in *Foster Lumber* and this case are not precisely the same, both cases held that the specific language of the Code overrode any argument that the result was contrary to what the taxpayer alleged to be the general congressional policy. Hence, it is not certain that the Second Circuit would adhere to its *Statler Trust* decision if the matter were presented to it again.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.,
Solicitor General.

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